



An ESOP Overview for ABC Contractors Inc.

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Introduction to ESOPs

What is an ESOP ?

- For Shareholders the ESOP is:
...a Buyer of Stock
- For Employees the ESOP is:
...a Company Funded Retirement Plan
- For the Company the ESOP is:
...a means of effecting a stock sale using pre-tax dollars
...a means of creating a tax-exempt corporation



What is an ESOP ?

- “Employee Stock Ownership Plan”
- Qualified retirement plan under IRS
 - Only retirement plan that can borrow money
 - Financial disclosure not required except in limited circumstances
- A trust created to own company stock
 - Employees do not own stock directly but are beneficiaries in the ESOP trust
- A “friendly” buyer of the company that provides tax savings for shareholders and companies and retirement benefits for employees
- A stock transaction that is planned and executed internally so confidentiality is maintained throughout the entire transaction process



Primary ESOP Uses

- ***Shareholder Liquidity and Diversification:*** Create an internal market for part or all of shareholders' stock
- ***Business Continuity:*** No change in management, leadership or board composition
- ***Personal Tax Elimination:*** Indefinitely defer capital gain taxation on the sale of stock to the ESOP
- ***Corporate Tax Elimination:*** Eliminate corporate federal and state income taxes
- ***Employee Participation:*** Retain, motivate and reward employees for their contribution to the company's success





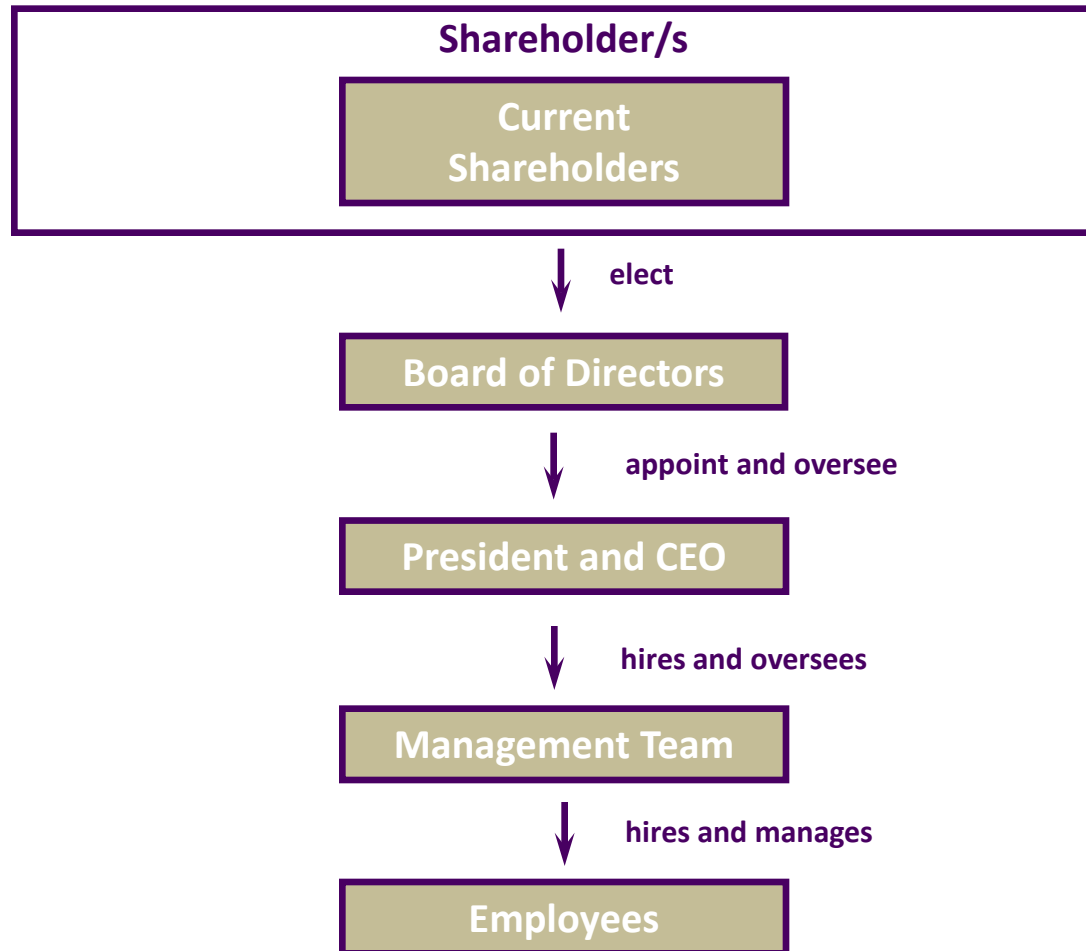
ESOP Basics

Beneficial vs. Direct Ownership

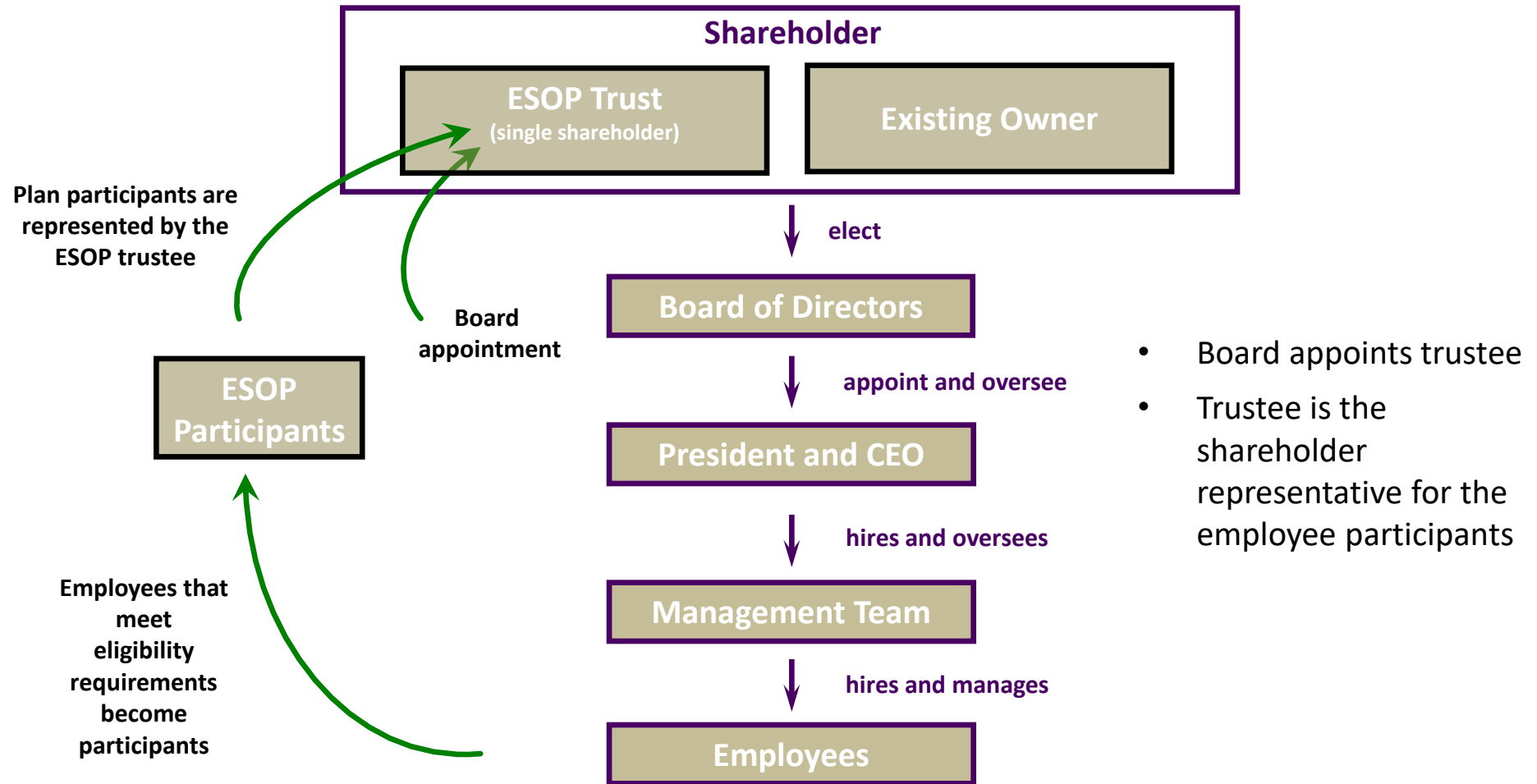
- Shares purchased by the ESOP are owned in a trust, **not** by employees directly
 - Employees become beneficial owners of the trust
- The ESOP Trustee represents the plan's interests
 - The ESOP Trustee is appointed by the Board of Directors
- The ESOP Trustee votes the stock owned by the ESOP, except in special cases
 - Special cases: merger or consolidation, sale of substantially all assets, liquidation, dissolution, recapitalization
- Employee participants are not entitled to company financial statements or the ESOP valuation



Company Structure: Before ESOP



Company Structure: After ESOP

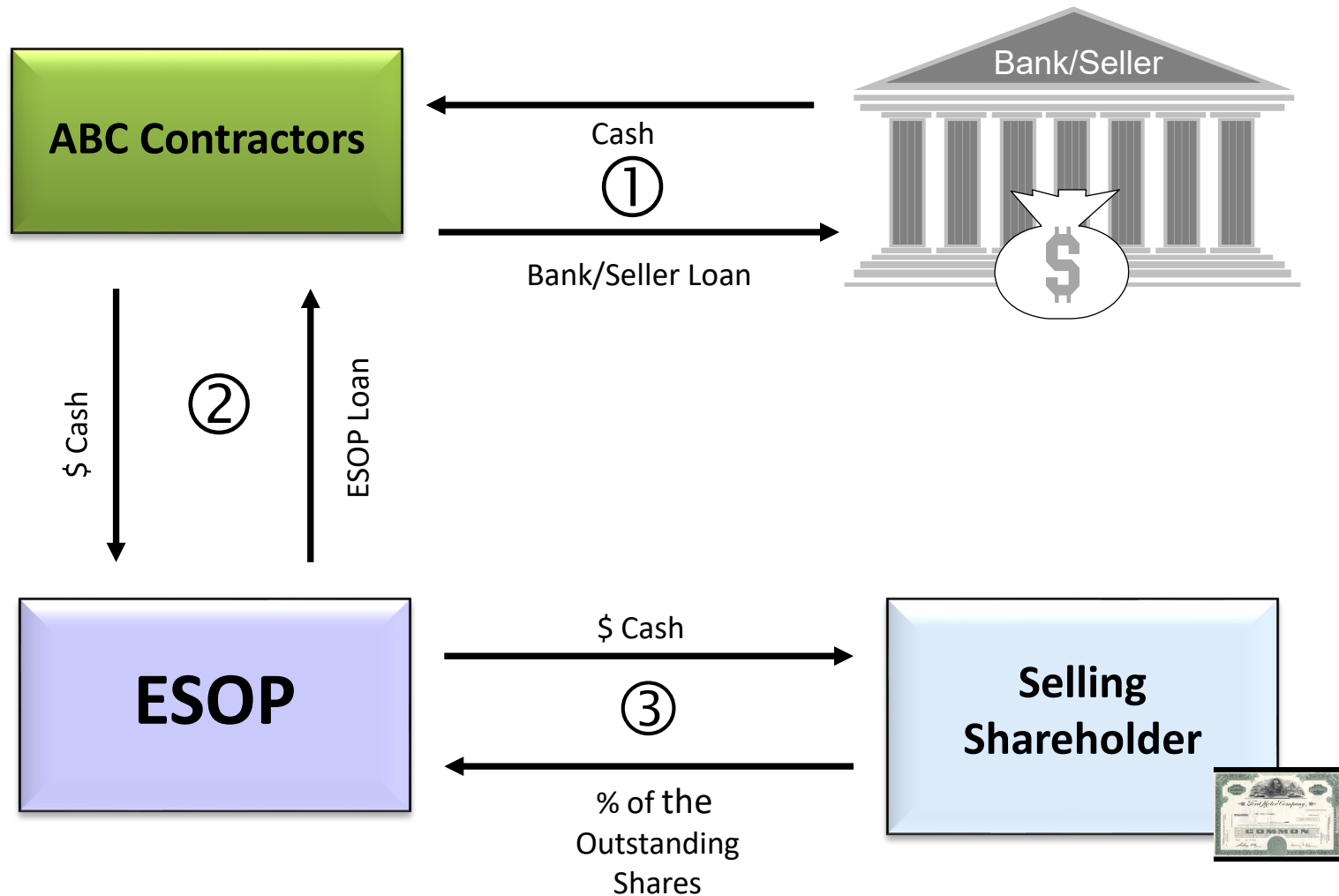


ESOP Transaction Steps

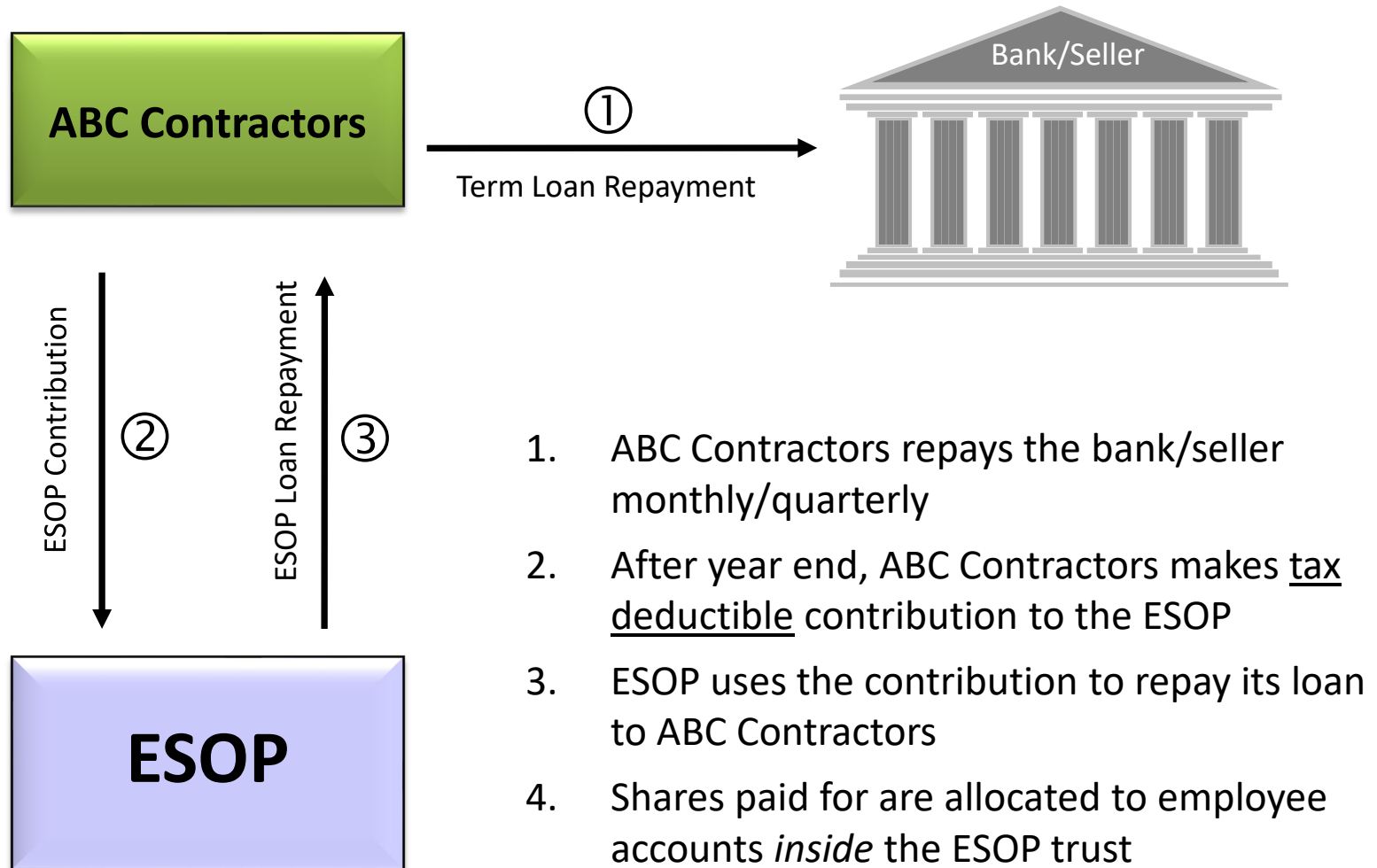
- Transaction planning
 - *Company's* ESOP advisor, e.g., Pilot Hill Advisors, completes pre-transaction planning which includes a valuation, transaction alternatives and financing structures
 - Financial impact analysis of different transaction/financial alternatives
- Stock transaction
 - Interview and retain an independent ESOP Trustee
 - Start due diligence
 - Make offer and negotiate offer with ESOP Trustee
 - Raise money (*from banks/sellers*) to finance to fund the ESOP purchase
 - Complete ESOP stock purchase



Typical Leveraged ESOP: Bank or Seller Financed



Paying Off the Bank and/or Seller Debt



Results

- Sellers realize proceeds which can be used to implement their individual financial and estate planning objectives
 - Tax deferral possible if structured properly
- Control of the shares acquired by the ESOP is exercised by the ESOP Trustee
 - The ESOP Trustee is appointed by the company Board of Directors
- Employees receive new retirement benefit that is tied to the success of the company
 - The benefit is paid out *after* they leave the company *and* over time
- Company repays transaction debt using pre-tax dollars



Recurring ESOP Administration

- Annual ESOP activity
 - Trustee updates stock valuation and votes shares
 - Board authorizes annual ESOP contribution
 - ESOP makes loan payment
 - Plan administration
 - Allocation of shares inside the ESOP
 - Compliance testing
 - Employee statements and ESOP tax return (IRS Form 5500)
 - Payout employee accounts when due





Shareholder Benefits

Primary Seller Benefits

- Ability to sell any percentage of company stock
- Selling shareholders are taxed at long-term capital gains rate on their value received less any basis
- Taxes are due when sale proceeds are received
 - Installment sale treatment on proceeds from seller notes
 - Taxable at the time/rate the principal payments are received
- Deferral of capital gain taxes
 - C corporations only
 - Tax and financial analysis determine if revoking S election and taking the tax deferral as a C corporation makes economic sense



Capital Gain Tax Deferral: Basic Requirements

- The ESOP capital gain tax deferral (aka, “§1042 Rollover”) is essentially a like-kind exchange similar to a §1031 property exchange
- Sellers of stock to an ESOP are eligible to indefinitely defer their capital gains taxation if:
 - Company is taxed as a C corporation at time of the ESOP transaction
 - ESOP’s ownership is at least 30% at the time or as a result of the transaction
 - Sellers must reinvest the proceeds in “**Qualified Replacement Property**” (“QRP”) within 12 months
- Capital gain tax remains deferred if/until QRP is sold
 - Several investment strategies exist for postponing taxation



Qualified Replacement Property

- ESOP proceeds invested in the following securities are not taxed:
 - Investments in stocks, bonds, notes, debentures of U.S. corporations, public or private
 - Investment in a brother/sister company of the ESOP sponsor, but not a subsidiary of the ESOP sponsor
 - Investments in company securities that use 50% or more of their assets in active conduct of business (no passive investments, e.g., real estate)
 - Investment in company securities whose passive revenue exceeds 25% of total revenue
- The selection of QRP is required within 12 months after the ESOP transaction or three months before
 - Two notices to the IRS and one to the company are needed to finalize the “1042 rollover”



Primary Investment Strategies

- Passive Deferral Strategy
 - Reinvest proceeds in QRP and keep portfolio invested
 - Small changes can be made using traditional margin strategies
 - Disposition of QRP is taxed using company stock basis
- Active Deferral Strategy
 - Purchase long-term, floating rate, non-callable bonds, aka “ESOP bonds”
 - These bonds can be margined so the ESOP sale proceeds can be actively managed or cover that portion
 - Used for active management or for an ESOP sale that uses seller financing



Tax Deferred Sale Analysis

- Part of the transaction planning undertaken is a comparison of the taxable vs. tax deferred sale structures
- Decisions about whether or not to revoke the S election in order to qualify for the IRC §1042 rollover involve:
 - Shareholders would be *excluded* from participating in the ESOP, as are family member employees
 - Accounting and tax issues
 - If only a partial ESOP sale, future transaction possibilities and tax consequences
- Pilot Hill Advisors identifies the economics of each alternative providing clients the with details needed to make decisions with their financial and tax advisors





Corporate Tax Benefits

Primary Corporate Benefit

- A company's primary financial benefit is the ability to take tax deductions for the entire buyout cost of the sellers' shares
 - A \$10 million ESOP stock sale saves the company approximately \$3.2 million in taxes, assuming a combined 32% federal, state and city tax rate
 - Therefore, the government is paying for \$3.2 million of the transaction
- This reduces the cash cost to the company by the product of ESOP debt x company tax rate
- This benefit accrues whether or not the company is taxed as an S or C corporation and whether or not the sellers defer or pay taxes



Cash Savings: Redemption Debt vs. ESOP Debt

	Redemption		ESOP
Loan Amount (000s)	\$ 10,000	\$	10,000
Value of principal deductions	-		(3,200)
Net after-tax principal cost	10,000		6,800
Gross interest payments	2,195		2,195
Value of interest deductions	(702)		(702)
Net after-tax interest cost	1,492		1,492
Cash Cost of Debt	\$ 11,492	\$	8,292
Cash tax savings with ESOP		\$	3,200

** Assumes state and federal corporate taxes of 32%. Loan amortization is 5 years at 7% interest.*



S Corporation ESOP Tax Benefits

- S corporation shareholders are responsible for paying for their pro-rata share of a company's tax liability
- If the ESOP is the 100% shareholder of an S corporation, all of the company's taxable income is attributed to the ESOP
- Since the ESOP is a qualified retirement plan, it is exempt from paying federal and most state corporate income taxes on income attributed to it
- ❖ Therefore, an S corporation 100% owned by an ESOP is exempt from paying federal and (most) state corporate taxes
 - ❖ This tax exemption applies to whatever percentage of stock the ESOP owns





Employee Benefits

Employee Benefits

- Employees accumulate shares in their accounts over time and get paid out their vested balance only when they leave the company
 - Payout terms are set by the company
- The ESOP benefit is paid out in cash (not shares)
 - Employees do not pay income tax on the benefit until it is paid out to them – similar treatment as with 401(k) plans



Typical ESOP Rules

- Eligibility
 - Employees become eligible to join the ESOP once they've worked 1,000 hours over a 12-month period
 - The company establishes eligibility within the rules governing defined contribution benefit plans
- Allocations of company stock
 - Shares of company stock and contributions are divided among eligible employees using a formula, which is typically their relative compensation
- Vesting
 - Employees accumulate ownership over a period as long as six years
- ESOP payouts of vested benefits are made only after an employee leaves the company
 - There are typically no in-service distributions
 - Payouts are typically made over a 5-year period
 - Employees that retire start getting paid out immediately
 - Terminated (pre-retirement) employees start getting paid out after a five-year waiting period and then ratably over five years





Other Considerations

Issues For Consideration



Appraisal Considerations & Requirements

- Privately-held companies are required to have their stock price determined by an independent, third-party appraiser
- Appraisals for stock transactions will be as of the transaction date
- Company stock is also appraised annually for purposes of valuing the retirement benefit
- Different valuation methodologies are used depending on the industry
- Historical as well as normalized and company prepared projected earnings are considered
- Analysis of prior transactions or offers can be used, under certain circumstances



Other Considerations

- All entity types - LLC, S corps, C corps, Partnership - can have ESOPs so long as they are structured properly
- Closely-held real estate
- Company management depth
- Company financial statement scope (audit, review, compilation)
- ESOP Accounting
- Bonding capacity
- Debt capacity
- Company culture





Steps in the ESOP Transaction

Steps in ESOP Transaction Process

- Transaction Planning
 - Valuation, financing structures and transaction alternatives and impact analysis
 - Assess suitability for company and shareholder(s)
 - Board Presentation/Review transaction plan
 - Average duration, 4-6 weeks
- Transaction Execution
 - Retain ESOP trustee
 - Due Diligence
 - Financing – secure best financing
 - Negotiations and ESOP, loan and transaction documentation
 - Close transaction
 - Average duration, +/- 4 months from completion of feasibility study



Advisors in ESOP Transactions

- Company Advisors
 - Corporate Attorney, e.g., Kleinbard
 - ESOP Financial Advisor, e.g., Pilot Hill Advisors
- ESOP Advisors
 - ESOP Trustee
 - Appraisal Firm
 - Trust Counsel
- Lender Counsel (if leveraged with bank debt)





Your Presenters

Mary Beth H. Gray, Managing Partner, Kleinbard LLC



About

Mary Beth is a managing partner of Kleinbard and a partner in the Business and Finance Department. She practices in the areas of mergers and acquisitions (representing sellers and buyers), corporate finance, corporate governance, corporate restructuring, and executive compensation. Her practice has a special focus on business succession, including the sale of businesses to employee stock ownership plans (ESOPs) and other transactions involving ESOPs. She has extensive experience in mergers and acquisitions and has represented buyers and sellers in more than 300 transactions. She also acts as a thought leader and authors articles and presents on ESOPs.

Professional Memberships

- Member, ESOP Association
- Member, National Center for Employee Ownership
- Various ESPOP Company Boards

Accomplishments

- Most Effective Deal Maker, *The Legal Intelligencer* (2022)
- Pennsylvania Super Lawyers (2014-present)

Education

- Boston University School of Law (J.D., *cum laude*, 1993)
- Harvard University (A.B., *cum laude*, 1988)



About Kleinbard LLC

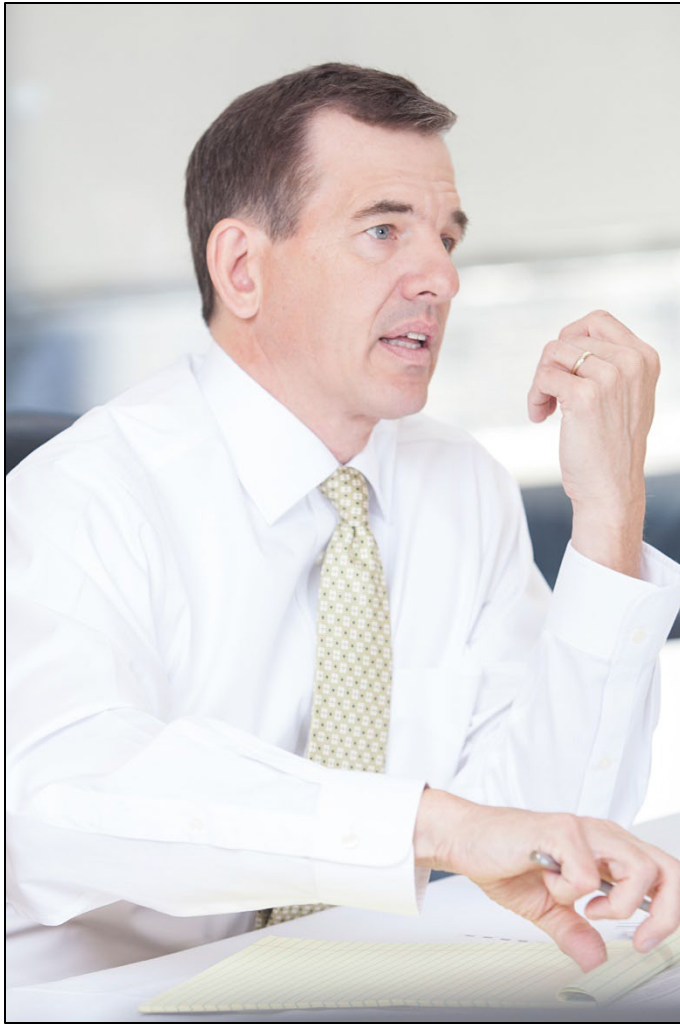
- For more than 80 years, Kleinbard attorneys (www.kleinbard.com) have served as trusted advisors and advocates to help clients achieve their goals.
- Our business and finance and litigation teams are recognized as among the most experienced and effective in our region.
- Kleinbard has represented more than 50 ESOP companies and completed more than 200 transactions involving the creation of, purchase by, or sale of an ESOP.
- Our clients are owners, operators and principals who need advisors who understand their business and can help them achieve their goals.
- In the construction industry, we have worked with sellers, executives and ESOP trustees to solve the unique challenges of ownership transition for construction companies. Our deal work has resulted in successful sales and the creation of stock benefits for thousands of construction workers.



KLEINBARD LLC



Robert E. Massengill, Co-Founder, Pilot Hill Advisors LLC



ESOP Advisory: 1995 to Present

Pilot Hill Advisors, Managing Director, Co-Founder
SES Advisors, Inc., President, Director, Shareholder
Menke & Associates, Vice President, Shareholder

Merger & Acquisition Experience: 1984 to 1995

Board Memberships

Kesslers Diamond Center, 2013 – Present
Trinity Logistics, Inc. – 2017-2018 (ESOP company acquired)
Queensgate Foodservice, 2012 –2013 (100% ESOP company acquired)

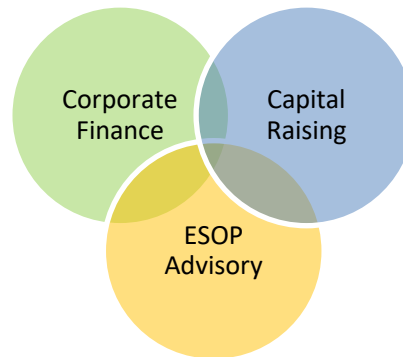
Education

New York University, Leonard N. Stern School of Business
New York, NY, MBA
Miami University
Oxford, OH, BS Business Administration



About Pilot Hill Advisors LLC

- Pilot Hill Advisors (www.pilothilladvisors.com) is an independent ESOP advisory firm that structures and implements internal ownership transitions for privately-held companies
- Our primary areas of expertise include corporate finance, capital raising and ESOP advisory services



- Our clients are predominantly company owners, management teams, corporate Boards and individuals
- Our principals have successfully executed over 300 ESOP transactions and capital raises for a variety of industries and company sizes



Recognized Leading ESOP Advisory Firm

- Our principals have over 50 years of combined ESOP advisor experience
 - Professional and presenting member of the ESOP Association, National Center for Employee Ownership, Vistage, ACEC and others
 - Active members of national ESOP organization events and various industry association committees
 - Speakers at numerous industry trade groups and professional organizations
 - Authors of technical articles written in ESOP related publications
 - Board members of ESOP companies
 - Geographically diverse client base and national reputation
- Construction companies are among our most frequent clients
- Offices in the greater New York City area and Detroit, MI



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